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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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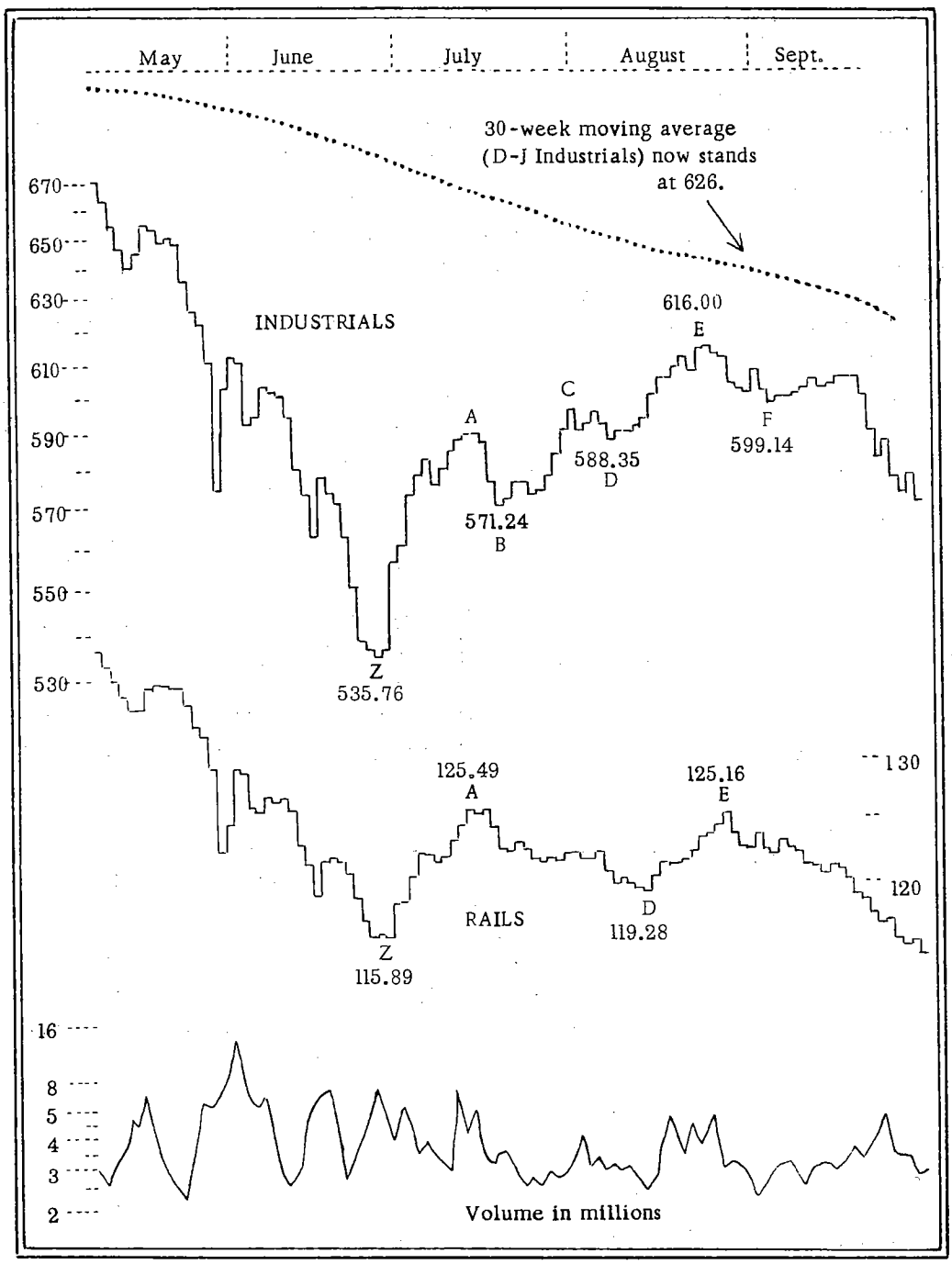
For a number of years (as a great bull market reached its crest) the American people wandered further and further from reality. Indeed, for a time the nation seemed practically to live on a diet of sloppy thinking and absurd cliches. "A market of stocks", "primative Russians", "growth stocks", "American world supremacy", "strongest currency in the world", "inflation in our time", "put 'em away for the kids"; these were some of the words and phrases that were tossed about with brainless abandon during the late 1950's and early 1960's.

The decline in the market (painful as it has been) and recent international developments have served to sober almost everyone but our President. Thus in a recent speech (Harrisburg) Mr. Kennedy informed his listeners that "...the decline in our position has been reversed and this country is moving forward again." In another speech Mr. Kennedy stated that inflation had been halted during the first twenty months of his Administration. Such arrogance surely must reap its own reward. Having checked inflation (throughout the world, I presume) and having sent this country on its forward course again, one wonders whether our President will also take credit for the bear market and the economic situation as it may develop during the remainder of his term.



THE MARKET The second leg of the bear market began for Industrials on March 15, 1962 (723.54), and continued to the June low of 535.76. This represented a total decline of 186 points. The correction which began on June 27 took Industrials to an August 23 recovery peak of 616.00. The Industrial recovery, in terms of percentages, measured 43.5%. The great market analyst Richard Schabacker once wrote that the percentage of recovery following a major decline often provides hints as to the inherent strength or weakness of the market. Thus if the rally following a

major decline succeeds in recovering around 50% of the ground lost, the market (or a stock) obviously appears stronger than would be the case if the rally succeeded in recovering only 33 or 40% of the lost pointage. Hamilton's statement that following a crash, one could expect a normal automatic recovery of 40 to 60%, might also be applicable in this regard.

Since the June-August, 1962, Industrial advance succeeded in retracing only 43% of the 186 points lost during the second bear leg, we are entitled to conclude that the market appears inherently weak. This line of reasoning, however, must not be considered infallible. For example, the second leg of the 1929 bear market erased 154 points from the price of the Industrial Average. The recovery into April of 1930 retraced 61% of the ground lost during the second bear leg. Obviously (in retrospect), this was no indication of fundamental strength, and the Averages declined drastically over the next three years. This notwithstanding, I feel that the "percentage of recovery study" is a valuable one.

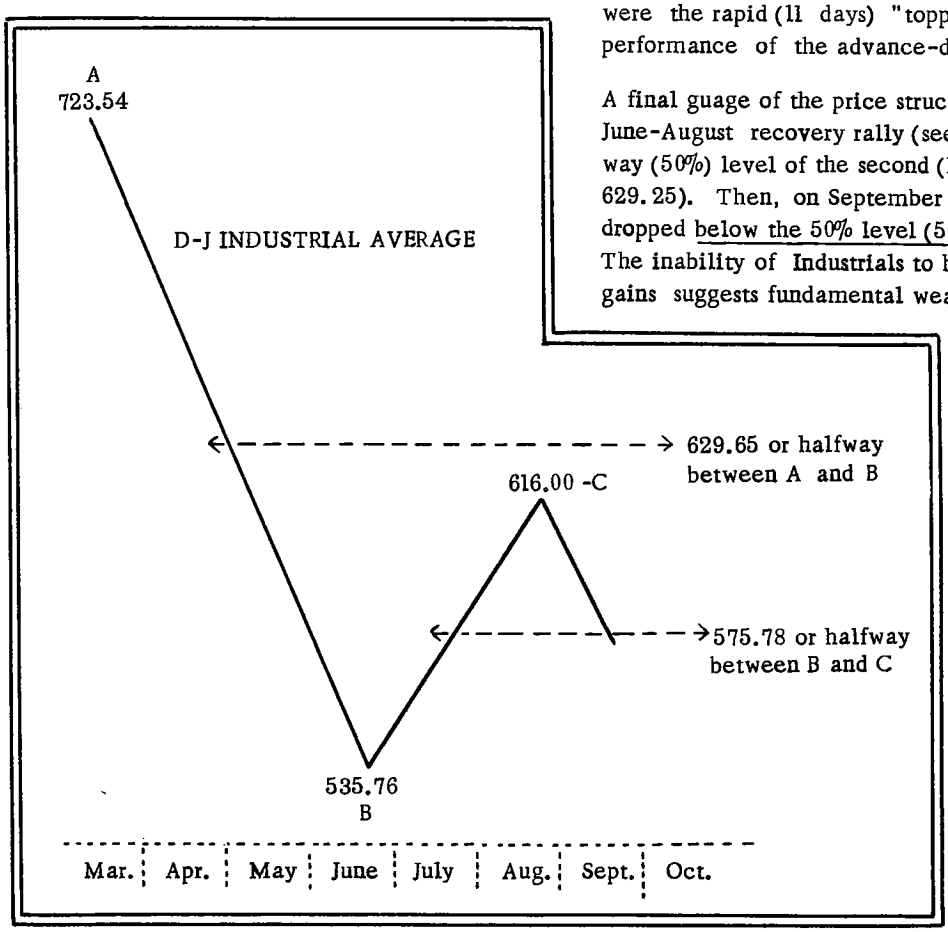
According to Dow's classic Theory, the primary trend (now bearish) is taken to continue in force until proved otherwise. During a bear market, joint penetration by the Averages into new low ground constitutes reconfirmation of the primary bear trend.

Letter 194 drew attention to the significance of the 119.28 (D) level on the Rail Average and the comparable 571.24 (B) level on Industrials. It was stated that although Rails had already penetrated the 119.28 point, "a full confirmation of Rail weakness would entail an Industrial violation of 571.24."

On September 27, Rails closed at 115.24, thereby establishing a new bear market low for the carrier index. Industrials closed the day at 574.12 (3 points above their B level and 38 points above their bear market low of 535.76). Thus Rails provided one-half of a bearish signal. While the primary trend must definitely be taken as continuing bearish, and while the great majority of primary penetrations by one Average are confirmed (eventually) by a penetration of the other Average, it must be stated that on strict Dow Theory interpretation, one-half a bear signal is no better than none.

For the near term, a persistent refusal by Industrials to penetrate (1) the 571.24 level and (2) the bear market low of 535.76 will suggest that a rally is in the offing. Such a rally might serve to correct 1/3 to 2/3 of the ground lost since the recovery peak at E (616.00). On the other hand, if Industrials violate first B (571.24) and then Z (535.76), the picture will appear ominously bearish. Such a move would reconfirm the primary bear trend; it would also be a further bearish prediction for the course of stocks and the economy.

From the larger viewpoint (despite possible rallies), the picture is hardly comforting. We witnessed a 43% (Industrial) retracement of a crash-collapse (and the normal range for such retracements runs from 40 to 60%). Further signs of technical weakness were the rapid (11 days) "topping out" of the Rail Average, and the poor performance of the advance-decline ratio during the June-August recovery.



A final guage of the price structure provides bearish implications. On the June-August recovery rally (see chart), Industrials failed to reach the halfway (50%) level of the second (March-June) bear leg (the halfway point was 629.25). Then, on September 27, as Rails broke to a new low, Industrials dropped below the 50% level (575.78) of the June-August recovery move. The inability of Industrials to hold at least one-half of their recovery gains suggests fundamental weakness in the price structure (see Letter 192--page 1).

CONCLUSION: Despite the possibility of a technical rally, the odds favor an Industrial penetration (in due time) of the 535.76 June low -- and a reconfirmation of the primary bear trend.

CHARACTER OF PRIMARY SWINGS In the last two Letters I outlined some of the implications of price action during and following a "crash." Actually, it is incredible that so little market research has been directed toward such subjects as severity of price swings and the resultant effect on stocks and the economy, duration of swings and subsequent action, effects of violent market movements, dull movements, etc.

This field has always fascinated me, and I have searched long and far for whatever authoritative writing I could find on the subject. Hamilton once wrote: "The (stock market) barometer does not profess to predict the duration of prosperity, although on close scrutiny it seems to give tolerably clear indications of the character of the boom or depression which it forecasts. The business depression of 1908-09, predicted by the bear market of 1907, was deep rather than long. The period of prosperity of the later part of 1909-10 was more extended but much shallower; and the bull market movement which preceded it was also slower and longer than the bear market, while its range was correspondingly less."

I have studied all bear market periods since 1896 from the standpoint of percentage of decline in the Averages, character of the market decline, length of the market decline, and the subsequent length, extent and violence of the decline in Barron's Business Index. The study is far from perfect, but I believe that Hamilton's use of the word "character" is valid.

Thus the relatively mild and short bear market of 1902-03 produced a rapid but mild drop of 15% in Barron's Business Index. The violent "Panic of 1907" gave way to a crushing drop of 29% in Barron's Index. The catastrophic 89% drop in the Industrial Average during 1929-32 produced an unprecedented 58% drop in Barron's Index. The precipitous 49% smash of 1937-38 was followed by a subsequent 38% contraction in Barron's Index. The 40% slide in Industrials during 1939-42 was due to World War II and all the unknown dangers inherent in such a struggle. The Averages were protecting themselves against excess-profit taxes, drastic changes in Industry and the possibility that the Allies would lose the war. During that period Barron's Index rose steadily, but the period (like 1914-17) must be considered completely abnormal.

The 25% drop in the Industrial Average during 1946 and the three-year trading range of 1946-49 was followed by a mild slide in Barron's Index from 119 to 113, a rise in late 1947 to 120 -- then an extended decline in Barron's Index to a 1949 low of 100.

In the current situation, the 1962 crash-collapse sliced 200 points (27%) from the Industrial Average in a period of six months -- with the major part of the decline being confined to a period of only four months (March to June). Thus, the drop was not a record-breaker in terms of percentages, but in terms of percentage of loss within a short period of time, it must be considered one of the more violent of the past 60 years.

With this historical perspective in mind, it is interesting to note the current comments from our nation's leading economists. Many view the crash as "a much-needed correction", while others insist that nothing has fundamentally changed. In fact, as late as September 27, Chairman Heller of the President's Council of Economic Advisers stated that he expected business to show a "continued moderate expansion throughout the rest of the year."

I disagree. As a pure guess, based on the character of the 1962 decline, I would not be surprised to see a rapid contraction in business starting in the next month or so (if it has not started already). How long the contraction will last will undoubtedly be forecast by the ability or inability of the Industrials to hold above their June (535.76) bear market low. An Industrial penetration of the 1962 low would suggest to this writer that the forthcoming business contraction will be longer and harsher than anything envisioned by the majority of the nation's economists.

NOTES A great moment -- on October 1 the New York Times became available to West Coast inhabitants on a same-day basis. This means (1) that the last intelligent argument for living in New York City has been removed, and (2) Californians no longer have a valid excuse for not knowing what's going on in the outer world.

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Eliot Janeway notes that in the first stage of the profit squeeze "activity is accepted as the standard of measure" and disappointing profits do not seem too disturbing. But "what makes the difference between the first and the second stages of the profit squeeze is the trend of product prices. If they now break -- and we fear they must and will -- management will begin to cut activity in order to cut out losses."

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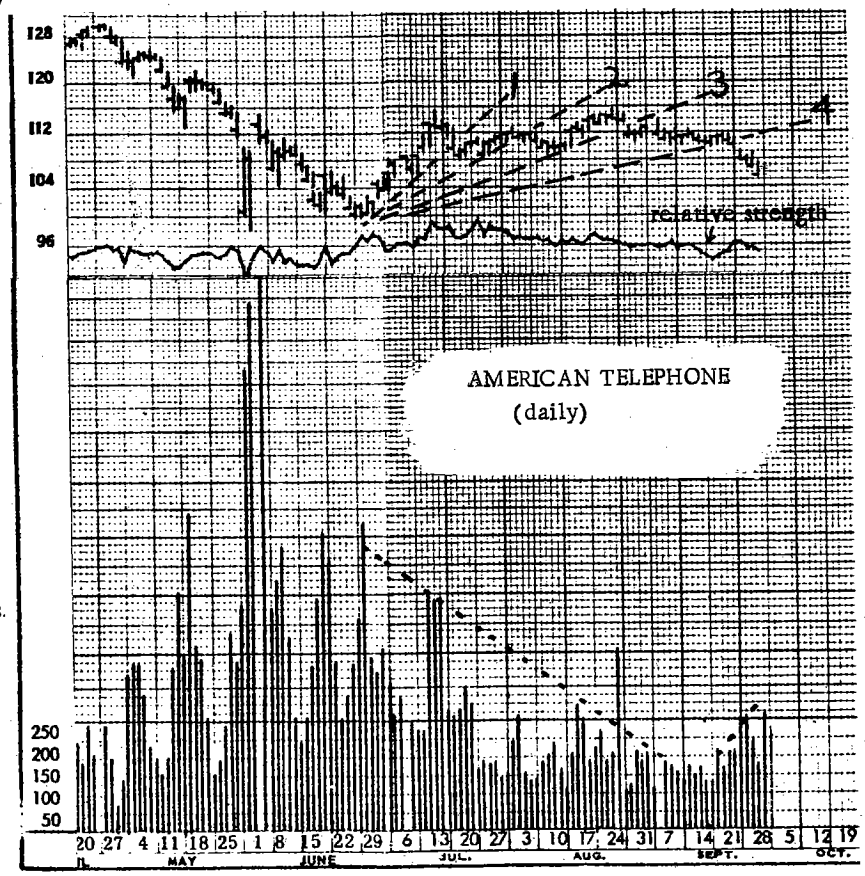
Commodity prices are diving, and I suggest that subscribers study the commodity chart in each issue of Barron's. This phenomenon is now exerting the most adverse influence on many industries in this country and is playing havoc with the "commodity-producing" nations of South America. In a word -- deflation has set in at the primary level throughout the world.

LATE MARKET NOTE (written Tuesday, October 2, 11 A.M. New York time). On October 1 the market closed with Rails at a new bear market low and Industrials within a point of the 571.24 level. This morning Industrials moved higher with Rails diverging (as has been their recent habit). A rally is overdue, but unless Rails can get "in gear" with Industrials on the upside, the rally promises to be a short-lived one. Volume on all rallying days since mid-August has been noticably absent -- a bearish indication.

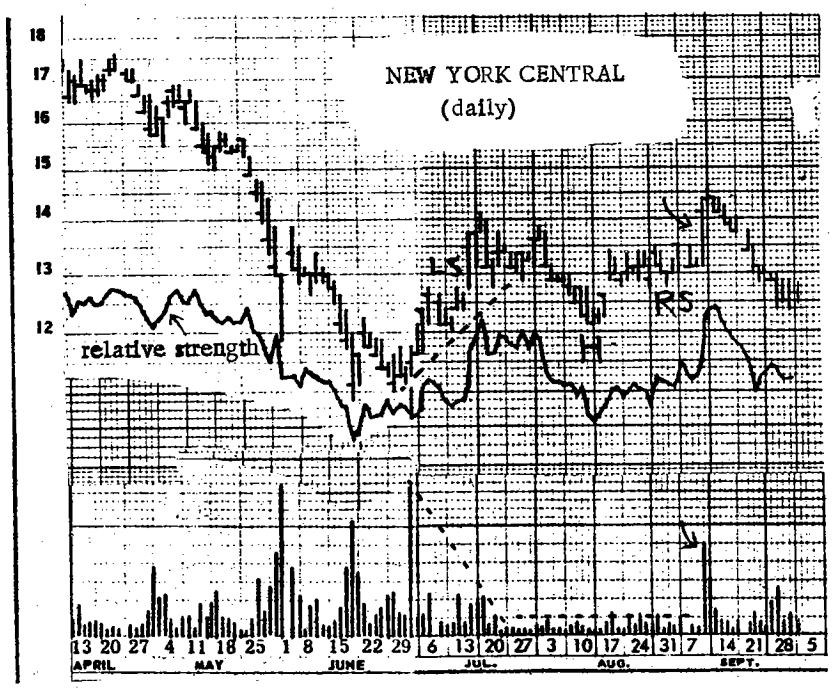
STOCKS Of the 346 representative stocks followed at this office, 12 are now holding above their 30-week moving average -- a drop of 21 since the last Letter. This sharp percentage decline implies that many of the stronger or "hold-out" issues are finally sinking with the rest of the market.

Letter 193 provided a detailed analysis of the leading institutional holding, IBM. Only a year ago people were saying that "IBM isn't a stock, it's a religion." We know now that the description was inaccurate; IBM was an "incipient collapse." The second leading stock is American Telephone, the most widely distributed stock in the nation. What "Big T" does is always important; it's action affects more people than does the action of any other single issue.

The daily chart shows Telephone's weak rally from its secondary June low (established following the crash). The steadily declining volume in T was hardly a bullish indication, but the picture appeared even less attractive when the "fanline principle" (see Letter 193) was applied. In the majority of cases (in a bear market) a violation of three fanlines is sufficient to start the downward action. Occasionally, a fourth fanline will develop as was the case with T. When the fourth fanline was violated, T started down on increased volume and broke its recent extended 108-116 range. I list the stock as a short (on a "pullback" to or near 108 if possible).



During a bear market insiders or large interests are prone to use any news or rumors to distribute stock. In early September, N.Y. Central leaped a point on very high volume on a rumor that a Presidential board would O.K. a merger. The move appeared to be a false one. First, note the "head-and-shoulder"-type pattern which appeared following the July rally. Accumulation patterns of this kind do not form after a rally -- they form at the termination of important declines. Next, note the decreasing volume on the July rally, and note the extremely dull volume on the rise from the head to the right shoulder (RS). As stated before, volume must rise on the move from the head to the right shoulder or else the pattern is suspect. Last, the excessive volume on the "breakout" was suspect, particularly in view of the complete lack of any volume build-up prior to the move. The September jump in Central appeared and still appears to be distribution. A move below 12 will now put Central in the "topped-out" catagory.



The following stocks appear particularly weak and should be added to last week's list of short candidates (short on a rally that goes dull): Freeport Sulpher, Westinghouse, Armour, Swift, International Paper, St. Regis Paper, Illinois Central, Northern Pacific, Woolworth.

Charts of Central and Telephone courtesy of Traders Research, Inc., P.O. Box 2644, St. Louis 16, Mo.